

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 98-43**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

How a limited liability company that makes loans to affiliates and is treated as a corporation for federal income tax purposes will be classified and taxed for Tennessee franchise, excise tax purposes and whether certain procedures will enable it to source income from its loans in accordance with applicable statutes.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

Corporation A is involved in the business of retail sales and operates retail outlets in several states throughout the southeast, including Tennessee. Corporation A will create an affiliated limited liability company (LLC) organized in Delaware and commercially domiciled in Tennessee. The LLC will elect to be taxed as a corporation for federal and state income tax purposes.

The LLC will derive more than 50% of its income from making, acquiring, selling or servicing loans or extensions of credit for unsecured commercial loans made to Corporation A and members of the affiliated group. The LLC will be the only institution in the affiliated group to derive more than 50% of its income from making, acquiring, selling or servicing loans or extensions of credit. It will, therefore, file independently of all affiliated companies and will not file a combined Tennessee franchise, excise tax return.

Corporation A and other affiliates will enter into a line of credit agreement with the LLC for a specified amount. The loan agreements will be authorized by each company's Board of Directors and will identify specific purposes for which the loan can be activated. The loan

agreement will mirror the specific purposes for which the loan may be activated, will not require any collateral, and will not require that the loan be secured by any real, tangible or intangible personal property.

The LLC will maintain an office only in Tennessee and its affiliates will apply for loans only in Tennessee. The following borrowing purposes will be included in both the Board's authorization and the financing agreement:

General operating expenses.

Capital and non-capital expenses associated with existing stores and new store openings.

Capital and non-capital expenses associated with relocating old stores to new locations.

Inventory purchasing costs.

Once Corporation A or its affiliates activate the line of credit, the funds borrowed will be deposited immediately into a separate cash account maintained by the borrower. When Corporation A or its affiliates pay vendor or dealer invoices for which the funds were borrowed, the money will be distributed directly from the cash account to the vendor. Amounts distributed from this account will be traceable back to supporting invoices. These invoices will identify the purpose for the expense and the store location that benefited from the expense. The payments made from the cash account will be tracked, identifying the states receiving the benefits of the payments.

Although the LLC will not have a physical presence outside Tennessee, it will conduct one or more of the business activities named in T.C.A. §§ 67-4-806(d) and 67-4-903(f) in [STATE A - NOT TENNESSEE] and also in other states besides Tennessee. [STATE A] will require the LLC to file an [STATE A] corporate income tax return and the LLC will file income and franchise tax returns in all states that require such filings.

QUESTIONS PRESENTED

1. Since the LLC derives more than 50% of its income from making, acquiring, selling or servicing loans or extensions of credit, will it be taxed as a financial institution for Tennessee franchise, excise tax purposes?
2. Since the LLC will file a corporate income tax return in at least one state other than Tennessee, will it be able to apportion its net worth and net income for Tennessee franchise, excise tax purposes even though it maintains an office only in Tennessee?

3. If the LLC maintains two offices, one in Tennessee and another outside Tennessee, does it obtain the right to apportion its income?
4. Will the procedures set forth above for tracking the use of loan funds be sufficient for proving the location where the proceeds from loans to Corporation A and other affiliates will be applied?

RULINGS

1. Yes.
2. Yes.
3. Yes.
4. Yes.

ANALYSIS

1.

**THE LLC IS A FINANCIAL INSTITUTION
FOR TENNESSEE FRANCHISE, EXCISE TAX PURPOSES**

T.C.A. § 48-211-101, enacted by the Tennessee legislature in 1994, makes the following provisions concerning the classification of a limited liability company for Tennessee tax purposes:

For purposes of all state and local Tennessee taxes, a foreign or domestic LLC shall be treated as a partnership or an association taxable as a corporation as such classification is determined for federal income tax purposes. The members of a foreign LLC treated as a partnership are subject to all state and local Tennessee taxes in the same manner and extent as partners in a foreign partnership. The members of a domestic LLC are subject to all state and local Tennessee taxes in the same manner and extent as partners in a domestic partnership.

The LLC is being treated as a corporation for federal income tax purposes. Therefore, the above quoted statute requires it to be treated as a corporation for Tennessee state and local tax purposes, including Tennessee franchise, excise tax purposes.

For purposes of the Tennessee corporate franchise, excise tax, T.C.A. §67-4-804(a)(7) defines a financial institution as follows:

"Financial Institution" means a holding company, any regulated financial corporation, a subsidiary of a holding company or regulated financial corporation, or any other corporation organized under the laws of the United States or any other taxing

jurisdiction that is carrying on the business of a financial institution. However, "financial institution" does not include insurance companies subject to tax under §§ 56-4-201 - 56-4-214.

T.C.A. § 67-4-804(a)(2)(A) defines the meaning of the phrase "business of a financial institution". Under Subparagraph (iii) of subitem (A), the "business of a financial institution" can be defined as:

Otherwise making, acquiring, selling or servicing loans or extensions of credit including, but not limited to, the following:

- (a) Secured or unsecured consumer loans;
- (b) Installment loans;
- (c) Mortgage or deeds of trust or other secured loans on real or tangible personal property;
- (d) Credit card loans;
- (e) Secured or unsecured commercial loans of any type;
- (f) Letters of credit and acceptance of drafts;
- (g) Loans arising in factoring; and
- (h) Any other transaction of a comparable economic effect;

However, T.C.A. § 67-4-804(2)(B) provides that, if the business of a financial institution generates less than 50% of a corporation's gross income, it will not be considered a financial institution.

Although the LLC is not a holding company (as is defined by T.C.A. § 67-4-804(a)(8)), a regulated financial corporation, or a subsidiary of a holding company or a regulated financial corporation, its activities are among those enumerated in T.C.A. § 67-4-804(a)(2)(A)(iii) and they generate more than 50% of the LLC's income. Therefore, for Tennessee franchise, excise tax purposes, the LLC is "carrying on the business of a financial institution" and thus will be classified as a financial institution under T.C.A. § 67-4-804(a)(7).

2. THE LLC IS SUBJECT TO TENNESSEE FRANCHISE, EXCISE TAXES AND IS ENTITLED TO APPORTION ITS NET WORTH AND NET INCOME

Tennessee corporate franchise, excise taxes are imposed on corporations for the privilege of doing business in Tennessee in corporate form. *First American National Bank v. Olsen*, 751 S.W.2d 417 at 421 (Tenn. 1987). The Tennessee Legislature clearly intends the franchise tax and the excise tax to be taken in tandem and construed together as one scheme of taxation. *Id.* The Tennessee Department of Revenue has a long-standing practice of administering its franchise, excise tax nexus and apportionment statutes *in pari materi*.

T.C.A. § 67-4-809 makes the following provisions concerning allocation and apportionment:

- (a) Any taxpayer having earnings from business activity which are taxable both within and without this state shall allocate and apportion its net earnings as provided in this part.
- (b) For purposes of allocation and apportionment of earnings under this part, a taxpayer is taxable in another state if:
 - (1) In that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
 - (2) That state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Although the LLC will not have a physical presence outside Tennessee, it will conduct one or more of the business activities named in T.C.A. §§ 67-4-806(d) and 67-4-903(f) in [STATE A] and also in other states besides Tennessee. T.C.A. §§ 67-4-806(d) and 67-4-903(f) name the following activities as “doing business” in Tennessee:

- (d) (1) A financial institution shall be presumed, subject to rebuttal, to be doing business in this state if the sum of its assets and the absolute value of its deposits attributable to sources within this state is five million dollars (\$5,000,000) or more.
- (2) Additionally, a financial institution shall be deemed to be doing business in this state if the institution:
 - (A) Maintains an office in this state;
 - (B) Has an employee, representative or independent contractor conducting business in this state;
 - (C) Regularly sells products or services of any kind or nature to customers in this state that receive the product or service in this state;
 - (D) Regularly solicits business from potential customers in this state;
 - (E) Regularly performs services outside this state which are consumed in this state;
 - (F) Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;
 - (G) Owns or leases property located in this state; or
 - (H) Regularly solicits and receives deposits from customers in this state.

The LLC will be required to file a corporate income tax return with the state of [STATE A] because of its business activities there, and it will conduct one or more of the business activities named in T.C.A. §§ 67-4-806(d) and 903(f) in other states besides Tennessee. Thus, the LLC is subject to an income tax in [STATE A] and will subject itself to the taxing jurisdiction of other states, even though such other states may not actually impose an income tax on the LLC. Accordingly, the LLC will be considered to be “doing business” both within and without Tennessee and will be entitled to apportion for Tennessee franchise, excise tax purposes.

3. MAINTAINING AN OFFICE IN ANOTHER STATE WOULD ENTITLE THE LLC
TO APPORTION FOR TENNESSEE FRANCHISE, EXCISE TAX PURPOSES

Maintaining an office in another state is one of the activities named in T.C.A. §§ 67-4-806(d) and 67-4-903(f) that, when conducted by a financial institution in Tennessee is considered to be “doing business” in Tennessee. Such an activity, when conducted by a financial institution in a state other than Tennessee would be considered “doing business” in such other state so as to entitle the financial institution to apportion for Tennessee franchise, excise tax purposes.

4. PROCEDURES ESTABLISHED BY CORPORATION A
AND OTHER AFFILIATES WILL BE SUFFICIENT TO PROVE
THE LOCATION WHERE LOAN PROCEEDS WILL BE APPLIED

Loans made by the LLC to Corporation A and other affiliates will be commercial loans that are not secured by real, tangible or intangible personal property. T.C.A. §§ 67-4-815(d)(4) and 67-4-919(d)(4), quoted below, state that the income from loans of this nature will be sourced to Tennessee if the proceeds of the loan are applied in Tennessee.

Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property shall be attributed to Tennessee if the proceeds of the loan are to be applied in Tennessee. If it cannot be determined where the funds are to be applied, the receipts are to be attributed to the state in which the business applied for the loan. As used in this subdivision, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first. For attribution purposes, "loan" does not include demand deposit clearing accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions;

Loan agreements authorized by the Board of Directors of Corporation A and other affiliates will identify the specific purposes for which the loan can be activated. When a loan is activated, the borrower will deposit the funds into a separate cash account established for that purpose. Vendor or dealer invoices, for which the funds were borrowed to pay, will be paid directly from the cash account in which the loan funds were deposited. The amounts paid from each cash account can be traced back to the supporting invoices and each invoice will identify the purpose for the expense and the store location that benefited from the expenditure.

The above described procedure will enable the LLC to determine exactly where the proceeds from each loan it makes are applied. Accordingly, the LLC will be able to comply with the requirements of T.C.A. §§ 67-4-815(d)(4) and 67-4-919(d)(4) which require income from unsecured commercial loans to be sourced to the state in which the loan proceeds are applied.

If, because the above described procedures were not followed or for some other reason, the LLC is unable to determine where the loan proceeds were applied, then T.C.A. §§ 67-4-815(d)(4) and 67-4-919(d)(4) will require the LLC to source all of the income from the loans in question to Tennessee because all of the loans were applied for in Tennessee.

Arnold B. Clapp, Senior Tax Counsel

APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: 10-21-98